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Condo Hotels

Making them work involves challenges and rewards.

Perhaps the greatest satisfaction of working in the real estate industry is that a single transaction can produce so many winners. Properly structured deals can offer up rewards for buyers, sellers, developers, lenders, consumers, builders, managers and operators, communities, and entire local economies. On the flip side, poorly structured deals often end up badly for all involved and get played out in expensive litigation. This is the context in which the industry must approach the current condominium hotel boom. Can

condo hotels be a win-win-win situation? Undoubtedly, yes. Can they also be a lose-lose-lose situation? Yes again—and developers, lenders, and other participants need to be protected against the inevitable fallout, as a badly structured condo hotel regime can have a bad impact on the hotel operator, the hotel brand, the customer, and array of financial players—all with a stake in the project.

Why such extreme scenarios? A successful condo hotel project demands that intricate legal and operational threads, each representing the competing interests of numerous parties, be woven together. A tight-

ly woven deal involves such complex structuring that even the most sophisticated of dealmakers can miss the many-layered details in their rush to participate in this profitable wave of development. Yet, it takes only one pulled thread for this delicate project tapestry to unravel.

The term *condo hotel* is used indiscriminately to refer to a divergent array of products with both residential and hotel components. Some condo hotels consist of a traditional hotel with primary residences that are not rented to the public. Others involve a hotel operation where some—or even all—of the rooms are condominiums owned by individuals who may make them available to hotel guests through a hotel rental agreement.

Condominium units may be branded with a hotel's name, or not. Condominium owners may or may not have access to hotel amenities such as housekeeping, room service, spa

privileges, parking, and the like. The income derived from renting a condominium unit as a hotel room may be accounted for by each unit (the general trend in the United States because of securities laws) or pooled and divided among participating condominium owners on a pro-rata basis.

Condominium participation in the hotel's rental management program may be voluntary or mandatory. Condominium owners may have unrestricted use of their units, or may be precluded from using them except during specified windows of time or on a space-available basis.

The current boom in condo hotels is driven by an unprecedented alignment of the economic interests of developers, consumers, hotel operators, and lenders. For hotel developers, the condo hotel model is a financing bonanza. Construction debt for hotel projects typically runs 50 to 60 percent of cost. When condominiums are added to a hotel project, equity credits earned through condominium pre-sales can provide debt financing approaching 90 percent loan-to-cost leverage. Developers are achieving significant front-end profits on the sale of condominium units in this scenario. And because the "hotel amenity" component creates a 15 to 40 percent premium value over the sale price per foot of comparable units, developers are also keen on the condo hotel model.

Consumers, particularly baby boomers nearing retirement, have an interest in owning real estate for both personal reasons and investment purposes. Owning real estate in a resort location, with hotel-style amenities and conveniences that are provided by a condo hotel, can be an attractive option. Add the investment potential—particularly through appreciation—and the possibility of defraying costs of ownership by renting the units out as hotel rooms, and it becomes easier to see why boomers are buying them. Also, the condo hotel has become a favored exchange property to effect tax-free exchanges under Internal Revenue Code Section 1031 and to facilitate the enormously popular tenancy in common (TIC) market.

Most hotel operators are happy to have a new supply of properties with which to expand their brands and to generate fees from the management and franchising of the condo hotels. They may also earn additional fees from renting out the units placed in the hotel rental management program and for managing various condominium homeowner associations (HOAs). They may even participate in royalty fees derived from licensing their names to the condominiums and collect a percentage of the sales price of units sold.



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Lenders are finding the financing of condo hotel conversion and development projects attractive because the presales of units eliminate substantial risk during the construction phase. Typically, such projects have a fast payoff as the condominium units are sold, transferring the lending risk to the mortgagee for the individual unit holders.

However, there are some drawbacks. The legal structure, design, construction, marketing, and hotel operation all affect one another. Seemingly simple changes in one aspect have a ripple effect on all the others. Throw in the concerns of hundreds of individual unit owners and there can be a potential minefield of problems. Once there is a rend in the overall fabric of a condo hotel deal, it can be impossible to mend because consent may be required from some or all of the divergent stakeholders.

Developers can refer back to the thorny legal issues surrounding the early timeshare market and apply those lessons when structuring condo hotel deals. Further, many traditional condominium developers entering the condo hotel arena know more than they probably care to know about construction defect litigation. The adverse impact of these concerns will be mitigated if deals are carefully structured on the front end.

Developers need to be hypervigilant in the marketing of for-sale units in a condo hotel project. If sales and marketing representatives are not properly trained and monitored, they can trigger liability under securities law that could ultimately wipe out a developer's potentially heady profits.

From a legal standpoint, federal and state securities law implications have a dominant influence on the structure and marketing of condo hotels. While a simple condominium sale usually does not involve the sale of a "security," a security will be involved once a condominium sale includes almost any discussion of rental management services—through a hotel or otherwise—unless strict limitations are faithfully observed.

The information provided in connection with a condominium sale cannot emphasize the economic or tax benefits of the rental arrangements, despite the investment motive of many condominium purchasers. In fact, about the only statement that can be made to a prospective condominium purchaser in literature or discussions is a bland statement to the effect that "ownership may include the opportunity to place your condominium in a rental arrangement." Any further inquiry by a prospective condominium purchaser must be

How to Make a Condo Hotel Deal

Challenges for the Hotel Operator

The hotel structure needs to be designed to handle the specific operator's particular market segment in a given location. The hotel operation needs an adequate supply of rooms on a predictable basis. Hotel operators will need to know the following:

- How many of the condominium units will be available as hotel rooms and when?
- Will an adequate number of rooms be available to handle large group meetings, usually booked 12 to 24 months in advance?
- How much meeting space will be needed?
- How many seats are in the restaurants and lounges?
- Is there a sufficient and stable supply of rooms to efficiently maintain needed staff and service levels for everything from front desk to maintenance and room service?
- Will there be enough hotel business derived from rental of rooms to support traditionally unprofitable or less profitable hotel operations that condominium owners expect or demand, such as food and beverage?
- How can cost allocations be kept flexible enough to meet experience and evolution, while protecting the reasonable expectations of the condominium owners?
- How can the operator be assured that capital will be available for the maintenance required to provide uniform room quality at required levels to satisfy hotel guests?

referred to the rental management company, which must maintain physically separate offices and staff. The rental management company's staff (but not the condominium sales staff) can provide interested purchasers with condominium sales and rental history of comparable properties, but this information cannot be edited or compiled.

Virtually all condominium and condo hotel regimes seek to avoid security status, using the guidelines handed down by the Securities and Exchange Commission (SEC), including a relative breakthrough in 2002 in the Intrawest "no-action" letter, which limits marketing the investment nature of the condominiums to prospective purchasers, pooling rental income of the units, and the restrictions developers may place on an owner's use of the unit.

Ironically, avoiding security status requires that no one provide projections of rental rates or expected occupancies. This deprives condominium investors of a great

■ How does the operator deal with a large number of condominium unit owners on issues requiring owner consent?

■ How does the operator fairly allocate room rental allocations among condominium owners and placate unhappy unit owners who find that their units are less desirable or produces less income than they hoped?

If the condo hotel structure cannot provide the operator with sufficient rooms and profit potential, the operator may be put out of business or exercise a termination right. Termination by the operator may mean that condominium owners and the lender find that the units cannot be put to productive income-producing use, and the project will fail. However, if the operator can manage the property reasonably well, then there are fewer of the typical operator concerns in a traditional hotel project that must accommodate owner exit strategies, such as termination on sale of the hotel or upon other specified events. In fact, condominium unit owners and lenders may be more concerned about having the operator "locked in" to protect their respective interests and property values for long periods of time than in other models.

Challenges for the Developer

The natural tug of interests between a hotel owner and an operator in the context of a traditional hotel provides certain checks and balances on the power of each, that may not be present if the developer has no ongoing permanent stake in the project. Developers will want to go into the deal with the following issues on the table:

■ Does the condo hotel developer expect to make all of its profit on the front-end sales of the units, or is it

deal of relevant and helpful information for evaluating their purchase. It also tempts aggressive salespeople to furnish the prohibited information on the side, which upon discovery could turn the whole scheme into an illegal offering of a security with attendant civil and criminal penalties, not to mention rescission rights for unit purchasers, which could run for many years.

Avoiding security status also means that the condominium unit purchaser can make only a voluntary decision to participate in the condominium rental management program after the purchase of the unit (at least after executing the condominium unit purchase documents, but possibly before closing of the purchase if the rental management agreement is contingent on such closing). For this reason, it would also be impermissible to place other restrictions on the condominium owner's personal use of his or her unit (such as might be contained in covenants, conditions, and re-

expecting to have value and cash flow from the residual hotel?

- What support, if any, will the developer lend to the project if cash flows in the cyclical hotel business run short, or if capital is needed to maintain the property?
- What capital calls and limitations are the homeowners associations (HOAs) subject to in order to support the project?
- What balance of hotel operator concerns and unit owner freedom maximizes the value and profit of the condominium program?
- Will unit owners be more inclined to sign up for the voluntary rental management agreement with the right operator if their use of their unit is limited, or does the value of having the potential for an income stream offset the inconvenience of limitations?
- Has the developer balanced the legitimate interests of the condominium unit owners and the operator in negotiating the form of hotel management agreement?

Challenges for the Unit Owner

Managing and satisfying the condominium unit owner's expectations will be a challenge, particularly given the securities law restrictions on information that can be provided to purchasers. A buyer who pays for a condo hotel unit at five times the price of a comparable "ordinary" condominium may be in for a rude surprise when the resale value of the property is disappointing or the owner's share of hotel revenues—after the operator's share; furniture, fixtures, and equipment (FF&E) reserves; and other carrying costs—is insufficient to cover debt service, insurance, HOA assessments, and other costs of ownership, much less provide a reasonable return on in-

vestment. Sophisticated condominium buyers will want to know the following:

- How will developers and operators keep an inappropriate speculative fever from breaking out, with unrealistic expectations of cash flow and profit from placing units in the hotel rental management program?
- Will the unit owners or the HOAs have the right balance of power and wisdom to effectively work with operators in the joint cooperative effort needed for the project to succeed?
- Can purchasers regard their condominium as an investment in real estate that may appreciate over time and that may not provide the return the investor would like on a near-term basis?
- Will the investor get good financial advice on realistic cash flow possibilities, and the capex (capital expenditures) requirements of using units as hotel rooms?
- Will the investor learn, for example, that the typical FF&E reserves of 4 to 5 percent of gross income may be enough to cover routine costs of maintaining a typical new hotel property, but over the long term, the capital required is substantially greater and comes in spikes at certain stages in the hotel's life cycle?
- How will the condominium owner control an inefficient operator or one who does not maintain the property well?
- What can be done to ensure fair rotation of available condominiums rented to hotel guests?
- Who will asset manage the operator when there is no single owner of the hotel property, but only individual unit owners and HOAs possibly lacking in hotel expertise?—**J.B. and G.M.**

restrictions [CC&Rs] or HOA documents) until after the unit is sold. A few rare exceptions may be available by private SEC no-action letter whereby some restrictions on use may be required to comply with local zoning laws or entitlements. And in certain instances, condominium owners may be encouraged to put their units into the rental management program by product location (e.g., a ski resort), design considerations (e.g., a 300-square-foot unit that is not suitable for long-term use), and economic incentives such as a greater share of revenues for use of the unit as a hotel room if the room is placed in the hotel rental management program for longer periods of time.

However, if the unit owner's decision to use the hotel rental management program is voluntary, and occurs after the purchase of the unit, the hotel rental management agreement, or a sale-leaseback, can extend for a long period of time (such as five or ten years) and can

limit or prohibit the unit owner's personal use of the hotel condominium. The agreement can also include other restrictions on the unit owner such as requiring a specified minimum notice prior to the owner's use of his or her unit. Limited use or prohibited use encompasses prohibiting an owner from ever occupying his or her unit, or prohibiting use by the owner for more than 30 days or 60 days, or during certain "blackout periods." That is related to but different from (or can be combined with) permitting an owner to use his or her condominium only if it is available some period of time before intended use, say 60 days. How else does a hotel operation know that it has an adequate inventory of rooms to guarantee that guests booking in advance will have rooms available? Of course, the more onerous the restrictions on the owner's use of the unit, the less potential buyers are likely to pay or the less likely many people are to buy the unit at all. Onerous restrictions in the rental program

agreement may also deter owners from placing their units in the rental management program, defeating a major goal and value of having condominium units as part of the condo hotel.

So why not structure the deal as a security and avoid these limitations? The advantages include the ability to pool income and expense from the project as a whole, to require mandatory participation in the rental program and to impose restrictions on owners to ensure an adequate inventory of hotel rooms, the ability to promote the project on the basis of the hotel rental management agreement, use projections of hotel rentals, and getting around many of the artificial restrictions required to avoid security status.

However, most developers shun securities compliance as too expensive, time consuming, and ill suited to the customs and practice of real estate sales. They do not want to offer and sell their units only through registered securities brokers and salespersons, or to comply with strict disclosure and liability rules. Many states have "merit review" of securities offerings, imposing daunting warnings of risk, high suitability standards, and limitations on the method of offering. The private placement exemption prohibits public solicitation of customers, and the intrastate offering exemption might work in some unique locations and circumstances, but is simply not feasible in others. Any misstatements or omissions of relevant information spawn securities fraud liability that potentially lasts for years.

There is no single formula that will make a condo hotel successful. Viable structures will vary by situation, regime, and circumstance. Developers need to appreciate that hotels are a different kind of real estate, and that condo hotels are a hybrid with unique issues, as well as significant opportunities.

The conflicting needs and interests of all parties must be reconciled through a complex layering of CC&Rs, HOA documents, rental management program agreements, hotel management agreements, operating business plans, and the like. Achieving a structure with the right balance of profitability potential and long-term viability is critical for a win-win-win-win project. If done properly—with the right expectations of all involved, and also the right structure, sponsorship, and integration of the hotel and condominium components—there could be a bright and long-term place in the mixed-use spectrum for condo hotels. The alternative presents an unnecessary blight on the industry that could last for years. ■